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New York, New York 10020

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February 1980

THE U. S. BUSINESS OUTLOOK

A FUNNY thing happened on the way to the recession...the consumers forgot to come along.

In fact, they decided to go the other way: In last year's fourth quarter consumers increased their purchases by more than 4% (on an annual basis), after inflation is stripped away. With inflation added in, consumption expenditures soared by more than 14%.

This continuation of the consumer spending spree was enough to cause inflation-adjusted (real) growth in 1979's fourth quarter of 1.4%--thereby confounding nearly all forecasters, who expected a decline in gross national product in the fourth quarter. What we forecasters did not foresee was the continuing---some might say astonishing---fall in the rate at which people save. That rate was down to 3.3% in the fourth quarter, half the average for the decade. Thus, even though their real income stayed flat, people were able to increase spending.

The key question then for the 1980 outlook is: Will the consumer quit?

The Consumer Conundrum

It's obvious the economy cannot keep growing by forever getting

injections of spending via reduced savings rates. True, the savings rate may stay depressed below historical norms for a long time because consumers--by now highly seasoned veterans of the 1970s' inflation wars--will be scrambling to cope with rising prices by buying sooner rather than later.

Also, the economy might be in for an extended period of low savings rates due to the shifting age structure of the population. The baby boom of the 1940s and '50s has become the young adult and middle age boom of the 1970s and '80s. And people in their twenties and thirties tend to borrow more and save less than other age groups as they begin families, buy homes, and otherwise accumulate an initial stock of possessions.

But even after acknowledging these developments, it must be noted that with the savings rate at 3.3%, there is just not much more room for it to fall. And that means further boosts to consumer spending will have to come from gains in disposable personal income or from increased borrowing.

Several things argue against a further burrowing into debt: One, the sharp rise in housing prices may be over, which means people will have less incentive to borrow on the increasing equity portions of their mortgages. Two, heavy recent borrowing at high interest rates implies high interest payments, which will reduce people's ability to take on new debt. Three, continued tight monetary policy would simply reduce the pool of loanable funds available to consumers.

Although it can't be said the above have already started to work, there is a little evidence that consumers have reined in their propensity for debt. The evidence is that the ratio of net change in installment debt to disposable personal income has declined by one half from the September peak of 3.2%.

As for disposable income, there is no reason to expect real gains in

the short term, unless consumers continue to rev up the economy by saving less and spending more. But as argued above, continued increases in spending would require pulling a rabbit out of a hat. And even if possible for a quarter or two, there are only so many rabbits a hat can hold. The scenario foreseen here is that final demand will be shrinking in the near term due to consumers' attempt to adjust their debt-laden balance sheets, and that this in turn will reduce employment, resulting in a fall in inflation-adjusted personal income.

In what way will the consumer cut back? Interestingly, consumers have already been backing away from purchases of durables. In fact, consumer durables have been going through their own separate recession, with real purchases in last year's fourth quarter down nearly 3% from the first quarter (nearly 4% annually). Durables purchases also fell in the fourth quarter compared to the third. This pattern of durables purchases is typical of a recession in the overall economy, yet the economy has continued to grow.

The driving force in consumer spending has been in nondurables, which grew by a smart 8% (annual rate) in real terms in the fourth quarter. Within nondurables, the growth has come mainly in clothing and shoes.

There are two messages contained in this mix of consumer spending. One is that since consumers have not been stocking up heavily on consumer durables, it's not expected they will suddenly stop buying them. That is, once people buy a durable good, they don't have to buy that type of good for some time; so if a lot of people were stocking up on such goods in a given year, sales in the following year would likely be very weak. However, since durables sales were sluggish in 1979, we don't expect a collapse in demand in 1980.

The second message is that nondurables spending should also weaken,

in part because of the recent large expenditures on clothing and shoes. Note that while clothing and shoes are categorized as nondurables, they share a characteristic of durable goods--they are not consumed immediately, but rather they render services over time. As a consequence, large purchases in recent quarters imply a cutback in the near term. Again, however, the slowdown should be moderate. All told, we hardly expect a debacle in consumer spending, although we do expect the physical volume of consumer goods purchased to decline this year.

Other Sectors: Less Puzzling But No Stronger

With consumption weak in 1980 will the economy get a boost from some other sector? Unfortunately, probably not.

Capital spending in 1979's fourth quarter fell in real terms relative to the third quarter. That fall, however, was in part due to strikes in the agricultural machinery and electrical machinery industries. These strikes have been settled, and as a consequence we expect capital spending in 1980's first quarter to contain a catchup element.

Moreover, since the main determinant of capital spending is the recent performance of the economy, and since the economy registered positive real growth in the second half of 1979, we expect some modest near-term buoyancy in plant and equipment spending. After rebounding in the first quarter of 1980, however, capital spending should show little strength until yearend.

In fact, key leading indicators of capital spending--new orders for nondefense capital goods and construction contracts--suggest some weakness. The nominal value of new orders has been steady in the past few quarters, which implies a decline in the physical volume of capital goods ordered. Similarly, F. W. Dodge data shows that construction contracts for commercial and industrial square footage flattened out in mid-1979, after a strong first

quarter.

More recently, contracts have picked up somewhat, implying that actual expenditures on business structures will come later in 1980. Capital spending will also be getting a boost in the latter part of 1980 as industry gears up for increased defense spending.

All in all, real business fixed investment should be down in 1980 by about 1%.

Inventory investment, meanwhile, should probably not have a sharp impact on gross national product this year, which is a good thing. The reason is that in a typical recession inventories pile up as business miscalculates final demand; then, once the recession is recognized, inventories are rapidly pared down, thereby reducing GNP and imparting volatility to the economy.

This time around, however, business has been keeping inventories in line with sales, so that sharp decumulations should not be necessary, even as sales fade.

The anticipated squeeze on housing arrived last quarter, when starts averaged about 1.6 million at an annual rate, down from more than 1.8 million in the previous quarter. The reduction in housing starts will be reflected in GNP next quarter, by way of residential investment.

Housing is expected to flounder even more as it continues to get buffeted by high mortgage rates and low mortgage availability. However, as interest rates fall due to a softening economy, mortgage rates will come down also, probably by midyear. Concurrently, lower interest rates (by damping disintermediation) and a higher savings rate should be pulling and pushing increased savings flows into thrift institutions. The result: a revitalized housing industry.

Meanwhile, though, consumers have been saving little. And due to the low legally mandated rates paid on savings accounts, they have no incentive to put what they do save into the thrifts. Consequently, net new savings received by savings and loan associations have been on the wain. During December, in fact, inflows were a negative $734 million, evidence that the mortgage market will be tightening further.

The rapidly evolving world political/military situation is obviously going to be a key factor in determining government spending this year. President Carter has asked for a 12% hike in defense spending for the year beginning October 1, but it is likely that current events in a volatile world will be steering the hands of both the President and Congress in 1980.

Further uncertainty on the government spending questions comes on the political/economic side: How much will the Administration try to stimulate a soft economy as election time--or perhaps nomination time--approaches? As we said in our last Outlook, we expect a tax cut later this year, although the size may be moderate in the face of increased defense spending and high inflation.

The net export account this year will be heavily influenced by two things: petroleum and the dollar. Oil-producing countries announced stiff price increases in December followed by further increases in January, and these actions will quickly show up on the U.S. trade balance. Partially offsetting the oil price hike will be continued strength in U.S. exports, which are being boosted by a fallen dollar. But the offset won't be nearly enough to get U.S. net exports back into the plus category.

For the year as a whole, then, we see small negative growth. But despite this sluggishness, there is not much hope for significant improvement

on the inflation front.

Inflation: The Beat Goes On

As already noted, oil-producing countries have been raising prices once again, which has obvious implications for inflation.

Another reason to expect inflation to stay high is that wages last year rose nowhere near as fast as did the consumer price index. And even though this index overstates inflation in periods when house prices and mortgage rates are rising, the consumer price index is the measure of inflation to which labor pays most attention. Consequently, 1980 should see workers playing wage catchup, with companies passing through their increased labor costs.

So even though the rise in house prices and financing costs are expected to moderate in the first half of 1980, inflation (measured by the consumer price index) will still likely remain in the double-digit area.

Towards midyear, the economy should be weak enough to pull inflation down a bit, but the country would be lucky if the rate of change in the consumer price index gets below the double-digit range. Neither is the longer-term outlook on inflation good, especially in the post-Afghanistan era of increased government spending. If this Administration or the next insists on both big guns and creamy butter (a la Lyndon Johnson), the groundwork would be laid for another surge in inflation, or for a round of tax boosts. And a tax boost, ironically, would add to the inflation tax already being levied on wage earners who have been pushed into higher tax brackets unadjusted for inflation.

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Department of Economics

February 1980

NATIONAL PRODUCT ACCOUNTS AND KEY ECONOMIC INDICATORS
(Billions of Dollars)

	Actual 1979		Forecast 1980				Annual		
	3Q	4Q	1Q	2	3Q	4Q	1978	1979	1980
National Product Accounts									
Gross National Product	2396.5	2455.8	2509	2546	2590	2647	2127.6	2368.0	2573.0
Consumer Spending	1528.6	1580.4	1621	1646	1679	1714	1350.8	1509.8	1665.0
Gross Private Domestic Investment	392.3	383.3	388	391	391	401	351.5	386.2	392.9
Fixed Investment	377.8	376.9	382	376	379	391	329.1	367.8	382.1
Nonresidential	261.8	261.3	271	273	275	278	221.1	253.9	274.3
Residential	116.0	115.6	111	103	104	113	108.0	113.9	107.8
Inventory Change	14.5	6.4	6	15	12	10	22.3	16.4	10.8
Government Purchases	477.8	499.8	513	521	530	542	435.6	476.1	526.5
Federal	162.9	177.0	183	186	189	194	152.6	166.3	188.0
State & Local	314.9	322.8	330	335	341	348	283.0	309.8	338.5
Net Exports	-2.3	-7.7	-13	-12	-10	-10	-10.3	-3.5	-11.3
Real GNP (1972 dollars)	1433.3	1438.4	1437.2	1427.0	1420.2	1421.0	1399.2	1431.1	1426.4
(% change at annual rates)	3.1	1.4	-0.3	-2.8	-1.9	0.2	4.4	2.3	-0.3
Implicit Price Deflator									
(% change at annual rates)	8.5	8.7	9.3	9.1	9.0	9.0	7.3	8.8	9.0
Key Economic Indicators									
Unemployment Rate (present)	5.8	5.9	6.3	6.7	7.0	7.1	6.0	5.8	6.8
Housing Starts (thousands of units)	1834	1604	1460	1425	1525	1675	2007	1722	1521.0
Consumer Price Index									
(% change at annual rate)	12.9	13.3	13.5	11.5	10.4	10.0	7.7	11.2	12.4